Investment Update

STILL CLIMBING THE WALL OF WORRY

For those unfamiliar with the terminology, the "wall of worry" is a phrase originated in the 1950's that refers to the impending headwinds facing investors. It can refer to political, economic, or technical factors. According to Investopedia, "the wall of worry is generally used in connection with the stock markets, referring to their resilience when running into a temporary stumbling block, rather than a permanent impediment to a market advance."

This phrase was carefully selected to personify the current investment climate—one riddled with challenges and obstacles. It's been rather easy to identify the challenges of investing in 2021: covid vaccination and variants, supply chain damage, worker shortages, a changing demographic and labor force, and rising inflation fears.

As we worked our way through the second quarter, the first half momentum showed no relent until it met September's newest wave of headwinds: political divide, the federal debt ceiling, Chinese regulation, and a decline in consumer sentiment. The S&P 500 entered the month +21.6% and left +15.9% YTD.

September could easily serve as the pessimist's "I told you so" moment. But looking deeper, we believe September represents a necessary period of volatility and repricing of risk. Perceived risks have risen in recent weeks. Nevertheless, the scale and speed of the repricing of risk is not of deep concern.

Historically, when significant market corrections are looming, one can turn to the bond markets for insights. When a true "risk-off" climate is emerging, safe havens like US Treasuries rally and non-investment grade credit sells off. So far, the recent bond market behavior suggests nothing more than an air-pocket of volatility. Credit remains healthy, spreads remain tight, and demand remains strong.

Corrections of 5-10% in equity markets is completely normal, to be expected, and in some ways healthy. Historically, the markets experience at least one 5% correction annually and 10% correction every 18 months. That isn't to applaud losses or suggest that losses are ever the target, but simply an acknowledgement that even "good markets" don't go straight up indefinitely. Given that September is also historically the S&P's weakest month, it isn't terribly shocking to see volatility surface at the end of the third quarter.

Below are the returns posted by the major global indices through the first ¾ of 2021:

- S&P 500 +15.9%
- Russell 2000 +12.4%
- MSCI EAFE +8.8%
- MSCI EM -3.0%
- Barclay's Agg -1.6%

Rest assured; the next few weeks'/months' headlines may conjure fear. Words like carnage, massive, precipitous, historic have recently led the storylines.

HOUSEHOLDS, CORPORATIONS, STATES AND MUNICIPALITIES ARE FLUSHED WITH CASH, SO DEFAULTS ARE OF LITTLE CONCERN

--FEDERATED HERMES

We are aware of the risks in the market and are monitoring and managing them daily. Part of that response is not reacting to every headline and news story. Part of our response is allocating to strategies that can help provide resilience in and through challenging times. For certain clients, raising cash for nearby cash flow needs is also appropriate.

DO WE JUST SIT STILL NOW?

From its recent all-time high, the Nasdaq 100 has fallen nearly 10%. From its March high to its September low, the Russell 2000 did fall 10%. How can we be confident when so much around us seems to be coming off the rails?

Perhaps taking a step back may help ask a better question. One can rarely predict days, weeks, or even quarters of investment market returns. Instead, identifying longer-term opportunities can be done with far greater predictability.

Let's identify a few of the positives:

- Housing demand is expected to remain high as long as affordability remains the norm
- Corporations have monstrous piles of cash for strategic acquisitions, share buybacks, capital projects, or dividend increases
- Private equity funds have an estimated $1 Trillion in "dry powder" to be deployed into equities in the coming quarters
- Corporate earnings have been remarkably strong and, despite headwinds from supply chain, seem poised to continue growth into 2022
- American households are sitting on $20.5 Trillion in cash, MMFs, and CDs (up from $14.5 Trillion in Jan '20). Those all return near 0%...that is unlikely to remain the case indefinitely
- US Banks are well capitalized and stand to benefit from loan demand and rising spreads as rates trend higher

As we enter the final quarter, we begin with a quick snapshot of the consensus and items left highly in flux:

- Consensus: GDP growth (both US & overseas) has moderated but remains positive looking forward
- In-flux: The Federal Reserve is expected to begin tapering in November and begin raising rates in late 2022
- In-flux: the Biden tax plan to raise corporate and individual rates has met significant resistance and poses a smaller risk than 3 months ago
- Consensus: there is extreme pent-up demand among global consumers and the inventory replenishment may contribute significantly to 2022 GDP growth

How should you be positioned for the balance of 2021?

There's a high probability that this answer is reflected in your portfolio today. **We allocate to strategies like covered calls, buffered ETFs, long-short managers, and fixed income to help take the sting out of the market's most challenging days.** Furthermore, many of these strategies can offer cash flow and can benefit from reinvesting in volatile market conditions.

- ➢ What if the Covid Delta is the final wave of scale in the US?
- ➢ What if the data starts to reflect US workers returning to work in droves during Q4?
- ➢ What if JP Morgan(4700), First Trust(5000), and many others are right in their year-end S&P 500 price target optimism?

During a storm, it can be difficult to see beyond what's right in front of us. Our job is to help build resilient portfolios that can allow you to weather such storms. It is our belief that this current "disturbance" could figure to be short-lived. ***We cannot control the markets' movement but we can control ours!***

IS ASSET ALLOCATION DEAD?

What possible benefit is there to owning anything other than the S&P 500? On a YTD basis S&P has outpaced nearly every major index. It's beaten Small Caps (R2000) by over 3.5%, Non-US (MSCI EAFE) by over 7% and the Barclay's bond index by 17.5%. The S&P 500 has been nearly the perfect mix of what has worked this year.

Suffice it to say, 2020-21 has presented a rather unusual investment backdrop for investors. From the "mobile work / stay at home" movement of 2020 to the "reopen" trade of early 2021 to the "Delta variant" positioning we see today, there have been massive and unprecedented repositioning moves in markets. Once volatile and "risk-on" mega-cap technology companies (think Microsoft and Apple) have become safe havens for investors, while smaller disruptors continue to emerge and grow at warp speed.

But what does all of that mean?

Succinctly put…more change is on its way. Such change is not only happening among large companies, but small as well. The US is not the only country addressing its challenges. The Emerging markets have faced a new challenge, but their middle-class emergence theme is not going away. Europe's need for technology enhancements is not going away. Movements toward sustainability are not likely going away. Demographic trends in aging countries (like the US and Japan) are not favorable to many parts of the economy. Though it has been rattling its saber, China does not seek to lose its hard-earned seat at the global economic table.

While US-based, dominant global brands have had a banner year so far in 2021 (and a great decade of growth), many of tomorrow's are likely to come from another group of holdings. Let's consider a few candidates outside of the S&P 500:

Small & Mid Caps: Smaller "disruptor" companies are at the forefront of addressing many of today's challenges. Unlike the startups of the Tech Bubble era, many of today's innovators are well capitalized, have seasoned management, and often have advisory boards with seasoned professionals to help them "grow up fast." Today's innovators and disruptors are quite capable of becoming tomorrow's Salesforce, Moderna, Adobe, and PayPal.

Developed European & Asian Equities: For more than a decade the US has dominated innovation and the global investment stage. That may continue. We do not believe, however, that one should completely ignore the valuation discrepancy of developed non-US equities relative to their US peers. Valuation alone is never a reason to invest but can help one identify opportunities. We believe an allocation to this region of the world (even if underweighted to its share of global GDP) is still prudent.

Emerging Market Equities: India and China combined house over 36% of the world's population. The opportunities for the emerging consumer in these nations, combined with parts of South and Central America and Southeast Asia cannot be ignored. While US juggernauts like Nike, Starbuck's, McDonald's and Tesla have huge presence in many of these markets, there are also many local companies likely to grow parabolically. Mercadolibre, Alibaba, and Tencent are only the tip of the iceberg of companies in these regions with such potential. Many more growth leaders are likely to emerge in these growing economies.

Bonds: The Barclay's Aggregate Bond Index is negative year-to-date. However, not all bonds are created equal. We believe one must think differently about investing in bonds today. Most of our clients' bond exposure has garnered meaningful gains this year because of the exposure to credit. We believe an actively managed fixed income portfolio can offer the historical benefits of diversification and still have a fighting chance for meaningful total return from the asset class. ***We do NOT anticipate bonds outpacing equities in the coming years, but also concede that they will still play a meaningful role in volatility and risk management.***

As one looks at the landscape of 2021, it would be easy to surmise that owing the S&P 500 alone is the only logical answer. According to Callan, over the last 2 decades coming into 2020, Large Cap Equities (represented by the S&P 500) was the top performing asset class only twice (2015 & 2019). Emerging Markets topped the list 5 times, Real Estate and Small Caps each 4 times, and US Fixed income 3 times. We simply believe that adjusting our lens to look closely at history shows us that this season is likely to change without notice. ***Asset Allocation is not dead, but we believe it must be looked at differently.***

UPCOMING EVENTS

December 7th

Details to follow soon…please mark your calendars.

LEARN MORE:

EXPLORE HOW OUR NOVEL STRATEGIES AND APPROACH TO RISK MANAGEMENT CAN HELP YOU TARGET YOUR PERSONAL GOALS IN THIS CHALLENGING ENVIRONMENT. CONTACT US TO SCHEDULE A COMPLIMENTARY STRATEGY REVIEW AND PORTFOLIO ASSESSMENT.

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